Supreme Court, U.S.
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No. 03-160

IN THE

Supreme Court of the United States

ADVOCAT, INC., DIVERSICARE LEASING CORPORATION, d/b/a RICH MOUNTAIN NURSING AND REHABILITATION CENTER, and DIVERSICARE MANAGEMENT SERVICES COMPANY,

Petitioners,

v.

LON C. SAUER, Individually, and as Administrator of the Estate of MARGARETHA SAUER,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF ARKANSAS

REPLY BRIEF

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PARTIES TO THE PROCEEDING AND DESIGNATION OF CORPORATE RELATIONSHIP

Petitioner Advocat, Inc., has no parent corporation and no publicly held company owns 10% or more of its stock. Advocat, Inc., is the parent company and sole shareholder of both Petitioner Diversicare Leasing Corporation, d/b/a Rich Mountain Nursing and Rehabilitation Center, and Petitioner Diversicare Management Services Company.

Respondent Lon C. Sauer is an individual and administrator of the Estate of Margaretha Sauer, deceased.

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The Arkansas Supreme Court's rulings as to punitive damages in this case present important constitutional questions regarding the application of the *Gore* guideposts in multi-defendant cases, the imposition of joint and several liability, and the due process requirements for post-trial proceedings, in particular where evidence crucial to a trial court's post-verdict determination of the constitutional excessiveness of a punitive damages award has been excluded from trial as unfairly prejudicial. Plaintiff mischaracterizes these issues as issues of jury instructions or sufficiency of the evidence. Contrary to Plaintiff's contentions, these issues address the constitutional standards for post-trial and appellate review of punitive damages awards. These issues go to the heart of the constitutional limitations on punitive damages and warrant review by this Court.

I. The Arkansas Courts' Refusal to Consider Evidence Submitted Post-Trial Regarding Defendants' Financial Conditions Deprived Defendants of a Constitutionally Adequate Review of their Due Process Challenge to the Punitive Damages Award

A. Under *Mathews v. Eldridge*, Due Process Mandated a Post-Trial Evidentiary Hearing

In opposing certiorari, Plaintiff does not address the three-part due process balancing test set forth in *Mathews v. Eldridge*, 424 U.S. 319 (1976). Under that test, the Arkansas courts' refusal to consider evidence submitted post-trial of defendants' financial conditions violated due process. *See* Pet. at 16-19. Plaintiff in its opposition does not claim that a limited post-trial evidentiary hearing such as that sought by defendants would be burdensome for the Arkansas courts. Nor does Plaintiff deny that the defendants' interest in such a hearing is substantial, and that such a hearing would protect against excessive and destructive punitive damages awards, such as that imposed in the instant case.[1]

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[1] Contrary to Plaintiff's contention (Opp. at 14-15), the federal constitutional issues raised by the trial court's refusal to consider evidence post-trial regarding the defendants' financial positions were briefed by defendants before the Arkansas Supreme Court and fully preserved. *See, e.g.*, Abstract and Br. of Defendants-Appellants at 491 ("By disregarding the affidavit (ADD-13), the trial court had no basis on which to review the financial standing of defendants. The punitive damages . . . violate rights

(continued...)

In asserting that there was no constitutional necessity for a post-trial evidentiary hearing, Plaintiff proffers an irrelevant list of Arkansas "procedural protections." *See* Opp. at 8-9. Those "procedural protections" do nothing to remedy the constitutional deficiencies caused by the refusal of the Arkansas courts to consider evidence of defendants' financial conditions. Plaintiff also relies upon judicial decisions that do not address the essential issues presented by the failure of the Arkansas courts to consider such evidence. None of the decisions cited by Plaintiff (Opp. at 11-13) addresses the need for a post-trial hearing where defendants' financial evidence has been excluded from the trial as unfairly prejudicial. None of those decisions considers the constitutional issues raised in such circumstances by a court's refusal to receive evidence that a punitive award exceeds the defendants' net worth. Plaintiff's contention that "no court has ever held that requiring all evidence to be presented during trial violates the due process clause" (Opp. at 8) not only misstates the specific issue here, but also disregards the decisions cited and discussed in defendants' petition that require or approve a post-trial evidentiary hearing on issues (including defendants' financial positions) relevant to the constitutional excessiveness review of a punitive damages award. *See* Pet. at 15-16, 18.

B. Plaintiff's Contentions Regarding Insurance Coverage Do Not Obviate the Constitutional Necessity for a Post-Trial Evidentiary Hearing in this Case

Plaintiff's contentions as to insurance coverage for the punitive damages award in this case have no bearing on the constitutional issues raised by the refusal of the Arkansas courts to consider evidence of the defendants' financial conditions. As courts across the country have held, evidence of insurance coverage is irrelevant in determining whether a punitive

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[1](...continued)
of these defendants guaranteed by the . . . United States Constitution[]."); *id.* at 489 ("Due process does not allow a state to exceed the scope of its legitimate interests in punishing a particular defendant through assessing punitive damages. *BMW of North America*, 517 U.S. at 568. Yet the punitive damages in this case alone have the potential . . . to destroy [defendants]"); Reply Br. of Defendants-Appellants at 7-10 (arguing that this Court's constitutional punitive damages jurisprudence dictated a post-trial evidentiary hearing).

award should be reduced because of a defendant's limited financial resources. Moreover, assuming that insurance is relevant, due process entitled defendants to show at a post-trial hearing that the punitive award could have a devastating effect on defendants even if the award is paid by insurance and that the award thus exceeded any legitimate Arkansas interest in punishment and deterrence.

i. Insurance Coverage Is Irrelevant to the Constitutional Propriety of a Punitive Damages Award in Relation to a Defendant's Wealth

In examining the propriety of a punitive damages award in relation to a defendant's net worth, numerous courts have refused to consider whether or not a defendant had insurance that might cover the award. The conclusion of these courts that the level of a defendant's insurance is not relevant to punitive damages is based on deeply rooted constitutional and common-law principles of proportionality and legitimate state interest. These principles require mitigation of a punitive award in relation to the defendant's financial condition, not the financial condition of his insurer. In *Liberatore v. Thompson*, 760 P.2d 612, 620 (Ariz. Ct. App. 1988), the Arizona Court of Appeals upheld the trial court's finding that punitive damages were excessive where "there was no basis in the evidence for concluding that [the defendant's] net worth even approached the jury's $500,000 punitive damage award." The court stated that a punitive damages award "must not financially kill the defendant." *Id.* at 621. The court emphatically rejected the plaintiff's argument that "any disproportion between the defendant's wealth and the punitive damage award should be disregarded, because the defendants have insurance." *Id.* The court explained:

> It is a defendant's own wealth, not his insurer's wealth, that bears on the proper level of punitive damages. Punitive damages are premised on the jury's expectation, sometimes a fiction, that the defendant himself will bear their punitive sting. We will not observe that premise to support the concept of punitive damages but abandon it to preserve a disproportionate award on the theory that "the defendant won't have to pay it anyway." *Id.*

Many other courts have reached the same conclusion. *See*,

e.g., *Michael v. Cole*, 595 P.2d 995, 997 (Ariz. 1979) (holding that insurance is *not* "an asset of the defendant" relevant to punitive damages even where the defendant has testified as to his poverty; rejecting plaintiff's argument that "unless he [was] allowed to comment on the defendant's insurance coverage, the defendant will be able to mislead the jury with evidence of his impecuniosity"); *Baker v. Armstrong*, 744 P.2d 170, 173 (N.M. 1987) ("punitive damages liability coverage is not an asset which can be used to measure true punishment" and "therefore, it should not be considered . . . in assessing a defendant's financial standing"); *City of West Allis v. Wisconsin Elec. Power Co.*, 635 N.W.2d 873, 889 (Wis. Ct. App. 2001) (citing *Baker*, holding that evidence of insurance was "not evidence of wealth" for purposes of reviewing a punitive award). Moreover, in *Owens-Corning Fiberglas Corp. v. Malone*, 972 S.W.2d 35, 41, 44 (Tex. 1998) upon which Plaintiff incorrectly relies (Opp. at 18), the Texas Supreme Court cited *Baker* and held that the trial court had properly excluded evidence of insurance coverage.[2] *See also Odoms v. Travelers Ins. Co.*, 339 So. 2d 196, 199 (Fla. 1976) (trial judge erred in ruling that "insurance policy's liability limits should be considered as an 'asset' of the defendant and . . . considered in assessing punitive damages").[3]

Similarly, courts have rejected the argument that a punitive damages award that is vastly disproportionate to the defendant's net worth may be upheld because the defendant would have other sources of indemnification, such as indemnification by his employer or a bad faith action against his insur-

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[2] In *Malone*, the Texas Supreme Court also approved the trial court's consideration of additional evidence on the issue of punitive damages at a post-trial hearing, including evidence of the defendant's financial condition. 972 S.W.2d at 44, 52.

[3] *Accord, e.g., Osborne v. Wenger*, 572 N.E.2d 1343, 1345 (Ind. Ct. App. 1991) (rejecting plaintiff's argument that "the trial court erred in allowing the defendant to testify regarding his minimal net worth, without allowing her to cross-examine him on the availability of insurance"); *Curry v. Giant Food Co.*, 522 A.2d 1283, 1290 & n.11 (D.C. 1987) (agreeing with Arizona Supreme Court's holding in *Michael v. Cole*, that "an insurance policy is not an asset of the defendant which the plaintiff can introduce into evidence on the issue of punitive damages" to rebut defendant's testimony "that they possessed little or no net worth").

ance company. *See, e.g., Rosenbloom v. Flygare*, 501 N.W.2d 597, 602 (Minn. 1993) (defendant's ability to pay, although not presented to the jury, was "a factor worthy of consideration in the exercise of our supervision over [punitive awards] even if the defendant is ultimately to be indemnified by another"). As a Florida appellate court opined, permitting consideration of a potential bad faith claim as evidence of net worth would result in "unlimited" punitive damage awards and "make the insurer 'responsible to pay damages in an amount that would never have been considered by the parties were the insurance company not the responsible entity.'" *Wransky v. Dalfo*, 801 So. 2d 239, 242 (Fla. Dist. Ct. App. 2001) (quoting *Battista v. W. World Ins. Co.*, 545 A.2d 841, 849 (N.J. Super. Ct. Law Div. 1988), *rev'd in part on other grounds*, 594 A.2d 260 (N.J. Super. Ct. App. Div. 1991)); *see also Carr v. City of Florence*, 729 F. Supp. 783, 787 (N.D. Ala. 1990) (emphasizing the "important difference between evidence as to a defendant's actual, personal wealth for use in arriving at an appropriate amount of exemplary damages, i.e., the sum necessary to punish him by an invasion of his pocketbook, and evidence of insurance coverage or third-party indemnity," which serves only to get into the "deep pockets of the indemnitor or insurance company").

Plaintiff relies on unpersuasive dicta from *Kemezy v. Peters*, 79 F.3d 33, 37 (7th Cir. 1996), for the proposition that if a defendant has insurance or indemnification, he should not be allowed to "plead poverty." *Kemezy* reasons that insurance itself "reduces the financial incentive to avoid wrongdoing" and that it "would be worse if the cost of the insurance fell, reducing the financial disincentive to engage in wrongful behavior" because insureds could plead poverty. *Id.* This rationale ignores the destructive financial impact a punitive award can have on a defendant even if the award is covered by insurance. *See* Point I.B.ii *infra*. This rationale also ignores the societal, individual and business harms that result when insurance rates for an industry providing necessary services skyrocket because of enormous punitive damages awards. *See, e.g.*, Br. of *Amici Curiae* Am. Health Care Ass'n, *et al.*, at 7, 14-19 (insurance rates for nursing homes have soared because of staggering punitive damages awards); Br. of *Amicus Curiae* Arkansas Ins. Dep't, at 3-13 (describing insurance price and availability problems for Arkansas nursing homes).

Moreover, businesses do not purchase insurance in order to circumvent the deterrent effects of punitive damages and engage in bad conduct without consequences. Rather, "the most careful [defendant] may wish to insure against the adverse finding of those charged with weighing the evidence to determine (by a preponderance) whether an act or omission constituted ordinary or gross negligence" meriting punitive damages. *Baker*, 744 P.2d at 173. As the New Mexico Supreme Court has pointed out, deterrence is not thwarted because punitive damages are insured – "the prospect of cancelled coverage or rated premiums is a strong deterrent . . . . for those who seek to maintain coverage against the eventuality of a punitive damage award." *Id.*[4]

In short, Plaintiff's contention that the punitive damages award will be paid by an insurance company has no bearing on the constitutional questions raised by the vast disproportion between the punitive award and defendants' net worths.

ii. Even If Insurance Coverage Were Relevant, a Post-Trial Evidentiary Hearing Is Constitutionally Required

In arguing that insurance coverage renders moot the constitutional issues raised by the disproportion between the punitive award and defendants' assets, Plaintiff relies upon partial and misleading quotations from Advocat's most recent 10-Q form. As Plaintiff notes, the 10-Q states that "the Company believes the [$26,425,000 compensatory and punitive damages in this case] will be within the Company's insurance coverage." Advocat Form 10-Q, 6/30/2003, at 12. Plaintiff omits the fact, however, that the 10-Q goes on to state that "to the extent the Company's professional liability insurance pays large amounts with respect to this verdict, there may not be sufficient insurance coverage for other claims during the same time period" and that the "ultimate results of all of the Company's professional liability claims and disputes are un-

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[4] Consideration of insurance is improper for the additional practical reason that it is often not clear whether an award of punitive damages will be covered until well after the punitive damages award has been rendered and appealed. Insurance coverage for punitive damages may depend upon whether a defendant's conduct was merely grossly negligent or whether it was intentional. *See, e.g., S. Farm Bureau Cas. Ins. Co. v. Daniel*, 440 S.W.2d 582, 584 (Ark. 1969).

known at the present time." *Id.* at 13. The 10-Q warns that "there can be no assurance that verdicts against the Company will not exceed the policy limits of the Company's insurance policies." *Id.* Thus, as the 10-Q makes clear, the $21 million punitive damages award, if permitted to stand, will consume a large portion of Advocat's insurance – which covers not just Rich Mountain, the nursing home at issue here, but all the numerous nursing homes owned by Advocat and its subsidiaries.[5] Given defendants' precarious financial conditions, the ultimate result could be that other claims for compensatory damages may go unsatisfied, that defendants may not be able to afford or obtain insurance in the future, and that defendants may face financial ruin. *See* Br. of *Amici Curiae* Am. Health Care Ass'n, *et al.*, at 14-19 (describing threat to nursing home industry from huge punitive awards and spiraling insurance rates); Br. *Amicus Curiae* of Ark. Ins. Dep't, at 3-13 (same).

Accordingly, insurance coverage does not alter defendants' due process entitlement to a meaningful determination, after a post-trial evidentiary hearing, as to the excessiveness of the punitive award in relation to defendants' financial conditions. This Court should grant review to clarify that consideration of a defendant's financial condition is an essential element of a constitutionally sound review of a punitive award.

II. The Arkansas Courts' Failure to Apply the *Gore* Guideposts Separately to Each Defendant Contravened Procedural and Substantive Due Process

Plaintiff does not dispute that the Arkansas Supreme Court

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[5] The 10-Q also states "participants in the health care industry have become subject to an increasing number of lawsuits alleging malpractice, product liability, or related legal theories, many of which involve large claims and significant defense costs. The entire long-term care profession in the United States has experienced a dramatic increase in claims related to alleged negligence in providing care to its patients – the Company is no exception in this regard." *Id.* at 37. Thus, "the insurance coverage limits available to the Company has declined significantly beginning in 1999. . . . [D]ue to the increasing cost of claims against the Company and throughout the long-term care profession in general, the Company's professional liability insurance premiums and deductible amounts increased substantially and insurance coverage limits decreased substantially during 1999 through 2002 and continuing for policy year 2003." *Id.* at 23. Advocat's Form 10-Q is available at www.sec.gov.

and trial court failed to consider each defendant's conduct separately in reviewing the constitutional propriety of the punitive damages award. Contrary to Plaintiff's contentions, an individualized evaluation of reprehensibility, ratio and comparable penalties with respect to each of the three defendants was required as a matter of due process. *See Gore*, 517 U.S. at 575 ("exemplary damages imposed on a defendant should reflect the 'enormity of his offense'") (citation omitted); *see also* Pet. at 20. Indeed, the Arkansas courts' group treatment of the defendants is directly in conflict with a new decision by the Ninth Circuit, which instructed the trial court that it must "evaluate the degree of reprehensibility of each of the defendant's misconduct individually, as opposed to *en grosse*." *See Bell v. Clackamas County*, 341 F.3d 858, 867 (9th Cir. 2003) (remanding discrimination case for individual evaluation of reprehensibility of conduct of each member of sheriff's office); *see also In re Exxon Valdez*, 270 F.3d 1215, 1242 (9th Cir. 2001) (considering relative reprehensibility of company defendant as compared to individual defendant).

Plaintiff argues that individual analysis of the *Gore* factors as to each defendant was unnecessary because the three defendants operated as "one business." Opp. at 23. In opposing defendants' motion for remittitur, however, Plaintiff expressly stated to the trial court that Plaintiff "never argued an alter ego theory with respect to any Defendant" but had tried "a case of direct liability against each corporation and the jury was instructed as such." Pet. App. 83a. Plaintiff also denied that it had "asked the jury to pierce the corporate veil and hold Advocat liable for the actions of its subsidiaries." Pet. App. 83a-84a. Under Plaintiff's own theory of the case, it was incumbent upon the Arkansas courts to address each defendant's conduct separately in applying the *Gore* analysis.

Moreover, even assuming that the defendants were operating one business, as Plaintiff contends, individualized application of the *Gore* factors was constitutionally mandated. Any three individuals or corporations might come together to operate a business, but their roles in that business, and the actual conduct of each, might be very different. Such was indisputably the case here (Pet. at 2, 24), and Plaintiff makes no contention to the contrary. Where the conduct is different, the relevant considerations about punishment are different.

The Arkansas courts committed constitutional error in failing to apply the *Gore* analysis to the conduct of each corporation.

The Arkansas courts' error was not confined to the reprehensibility guidepost. The ratio and civil penalties guideposts must also, as a constitutional matter, be calibrated to the conduct of each defendant. When this Court in *Campbell* set forth the principles governing application of the ratio guidepost, it emphasized the need to consider "the facts and circumstances of the defendant's conduct." 123 S. Ct. at 1524. Because the Arkansas Supreme Court ignored the facts and circumstances of each defendant's conduct, its ratio analysis failed to "ensure that the measure of punishment is both reasonable and proportionate." *Id.* Furthermore, Plaintiff's contention that the punitive damages award in this case is sustainable by reference to purportedly applicable criminal penalties (Opp. at 24) is erroneous. Plaintiff not only disregards this Court's admonition as to the limited utility of criminal penalties in the due process punitive damages analysis, *Campbell*, 123 S. Ct. at 1526, but also (like the Arkansas Supreme Court) refuses to acknowledge that differing civil penalties would be relevant to the defendants' differing conduct.

Plaintiff also incorrectly argues that the $21 million punitive award is sustainable because the harm in this case was physical. Plaintiff, like the Arkansas Supreme Court, ignores the principle laid down by this Court in *Campbell*, that "[w]hen compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee." *Id.* at 1524. This Court did not condition the applicability of that principle on the character of the harm. *See id.* Plaintiff also disregards the punitive and deterrent effect of the remitted compensatory award, a still very high $5 million. *See* Pet. at 23-24.[6] Certiorari is warranted to review and correct the Arkansas Supreme Court's misapplication of the *Gore* guideposts.

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[6] Plaintiff also does not address, much less attempt to defend, the trial court's extreme and improper deference to the jury and its failure to treat the constitutional excessiveness inquiry as a question of law for the court. *See* Pet. at 20-22.

III. The Arkansas Supreme Court's Imposition of Joint and Several Liability for Punitive Damages Contravened the Due Process Principles Set Forth in this Court's Punitive Damages Jurisprudence

Plaintiff attempts to deflect the constitutional concerns posed by the Arkansas Supreme Court's *sua sponte* imposition of joint and several liability for punitive damages by an irrelevant and incorrect discussion of jury instructions. Plaintiff erroneously contends that "[a]t trial the Advocat defendants were content to allow the case to go to the jury with instructions that treated all of the Advocat Defendants as one." Opp. at 19. In fact, it was never disputed in this case that the standard Arkansas instruction should be given, telling the jury that each defendant was "entitled to a fair consideration of his own defense" and that "each defendant's case" should be decided " as if it were "a separate lawsuit." Pet. App. 155a. That instruction reflected the theory of direct liability against each defendant upon which Plaintiff tried this case – a theory that is irreconcilable with the Arkansas Supreme Court's imposition of joint and several liability for punitive damages.

Contrary to Plaintiff's contentions (Opp. at 19-21), the issue of joint and several liability has nothing to do with jury instructions or sufficiency of the evidence and is not a factual issue as to whether the three defendants "operated one business." The trial court recognized that defendants were separate corporate entities (Pet. at 6 n.3), and Plaintiff acknowledged after trial that it did not sue on an alter ego theory but instead sought to hold each corporation liable for its own individual conduct. Pet. App. 83a-84a. The Arkansas Supreme Court's decision to render each defendant jointly and severally liable for the entire amount of punitive damages in this case violated the due process rights of each defendant, because it resulted in an award that had no reference to each defendant's conduct and culpability. *See* Pet. at 26-29. Certiorari should be granted to clarify that a joint and several punitive damages award that erases the significant differences between defendants is constitutionally impermissible under this Court's punitive damages jurisprudence.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully Submitted,

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